

DR. KURT RICHEBÄCHER

Muehlelegasse 33
CH-8001 Zuerich
Switzerland

CURRENCIES AND CREDIT MARKETS

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The Western financial system is rapidly coming to resemble nothing as much as a vast casino. Every day games are played in this casino that involve sums of money so large that they cannot be imagined. At night the games go on at the other side of the world. In the towering office blocks that dominate all the great cities of the world, rooms are full of chain-smoking young men all playing these games. Their eyes are fixed on computer screens flickering with changing prices. They play by intercontinental telephone or by tapping electronic machines. They are just like the gamblers in casinos watching the clicking spin of a silver ball on a roulette wheel and putting their chips on red or black, odd numbers or even ones.

Casino Capitalism, Susan Strange, p.1
Basic Blackwell, 1986

HIGHLIGHTS

Within currency markets, such a lack in sense of direction prevails, that conditions have not been more volatile in years.

Of all recent events, the one that is most astounding and to this point the least recognized, concerns West German long-term capital outflows. Outflows have stopped dead in their tracks while foreign investors have stepped up their purchases of German stocks and bonds.

Here we have a massive differentiation between those capital flows impacting short-term fixed-income markets and those of longer-term fixed-income markets. Could it be that the excellent performance of Europe relative to that of the U.S. is finally beginning to filter down into financial markets?

Savings is the long-term governor of inflation for a country since its level essentially sets the limit to investment and productivity growth potential.

In the U.S., the deep underlying aquifers of inflation - poor savings and productivity growth - rather than indicating improvement for U.S. inflation trends, point to a worsening picture in the future.

In the case of the U.S., one has to realize that private and public consumption absorb 97-97.5% of net U.S. GNP. That means that investment, and any other type of control on domestic inflation for that matter, is critically dependent on foreign capital inflows.

For the sake of international interest rate and inflation rate comparisons, one cannot ignore the over-riding determinant to any medium-term forecast: the critical link to the ebb and flow of international capital flows.

The widespread failure to recognize the distortional effects of massively imbalanced international capital flows will prove to be the Achilles heel that fells the thinly-supported colossus of positive psychology.

THE CURRENCY CASINO

Trying to understand or explain the recent gyrations of the U.S. dollar is probably not worth the trouble. For the time being, currency markets are ruled by one single motive: to make a fast buck many times over whatever the direction of prices. To that end the more volatility the better.

This kind of trading mentality is "short-termism" in the extreme. Much of it, if not most of it, is in fact "technical day trading" and not the kind associated with longer-term investment positioning or the establishment of hedges. Trading of this sort has boomed as ever-increasing numbers of currency traders seek to supplement profits through their trading skills. In that respect, anything goes whether charts, hearsay, gossip, rumours, rumours on rumours, unexpected economic data or mere changes in opinion or moods.

Objective changes in underlying market conditions seems to have rather little to do with it. Since many follow the same theories and charts, the trading systems become self-fulfilling and self-reinforcing. It all makes an interesting case study for one of the latest academic discoveries: chaos theory.

OUT OF THE PITS AND INTO THE CASINO WITH DETERIORATING HOUSE-ODDS

Although the U.S. dollar has fallen from its highs of June, the currency is still showing surprising resilience especially when one considers a sharper slowing in the economy than was widely expected and the surprisingly sharp drop in interest rates. Rather, these developments were seen as pleasant surprises and fuelled bullish sentiment all around with the "triple rally" of currency, bonds and stocks.

Yet, in the currency markets, a lack of sense of direction prevails which has been translated into one of the most volatile periods of foreign exchange trading in recent years. A fairer way to characterize the situation presently might be to say that accentuated currency fluctuations reflect pure gambling rather than genuine capital flows.

But of all recent events the one that is most astounding - and to this point the least recognized - concerns West German long-term capital outflows. Outflows have stopped dead in their tracks while foreign investors have stepped up their purchases of German stocks and bonds. That presents a staggering contrast to investment flows in 1988 and in the first quarter of this year.

SUDDEN REVERSAL IN GERMANY'S CAPITAL BALANCES

The German balance of capital has radically reversed over the last few months. The reversal occurred along two major fronts. On the one hand, German net purchases of foreign-currency bonds receded sharply from DM 21.4 billion in the first quarter of 1989 to DM 5.2 billion in the second quarter - a huge drop of 75%. On the other hand, foreign investors reversed direction increasing their holdings of DM-bonds by a net amount of DM 8.3 billion, after having sold a net position of DM 7.5 billion in the previous quarter. For a nation characterized by huge surpluses this change in capital flows is no small matter even though the resilience of the U.S. dollar wants to warrant complacency on this point.

As a result of the above two sea changes, the net balance of capital flows alone - which reflects through the fixed-income markets alone - swung about-face from a record deficit of DM 28.9 billion to a surplus of DM 3 billion. This is the first net inflow in two years. Even though, this sharp turnaround failed to impact the currency market for one reason: it was counterbalanced by stepped-up short term outflows.

Motivations of Long-Term Money Changes. Given the relatively low level of German nominal yields, it is obvious that the foreign buyers of DM-bonds are attracted by potential currency gains, but probably also by the growing perception that the economic and inflation outlook is far better than many recent reports (from British and American brokers) are suggesting. Enveloped within that rationale may also be the quest for the safety of a "hard money" currency.

The reason for the sudden, drastic relapse in German investor's foreign bond purchases is even more obvious. It was the repeal of the new 10% withholding tax. In hindsight, one realizes that the announcement and introduction of this tax caused a veritable capital flight. The sudden halt of this outflow certainly confirms the suspicion of a large-scale tax evasion on interest income.

For foreign readers, it should also be noted that there is no requirement for German banks to disclose information to the tax authorities on interest income, as is the case in most other countries. For most Germans, capital income is therefore tax-free income and is probably is the major reason why Germans are such good savers. But there is a further interesting point to the nature of German capital outflows which, incidentally, highlights and explains a crucial distinction between German and Japanese international investment flows.

GERMAN AND JAPANESE INFLOWS: INDIVIDUALS VERSUS INSTITUTIONS

In the case of Japan, the overwhelming influence on its international capital flows are its large financial institutions (mainly insurance and pension funds) who are heavily-engaged in short-term trading activities. Simply because of the size of these Japanese institutions, the fact is that most international markets are not suited to accommodate their investment and trading needs. It's little wonder then that U.S. dollar markets and Wall Street almost captures the full attentions of these Japanese giants.

The foreign investment activity of West Germany is of an entirely different breed. Predominantly, foreign capital flows are governed by individuals and not major financial institutions. These individual investors generally buy "for keeps". Not surprisingly, they don't care about a market's depth and breadth. Seeking primarily high nominal yields, they shop everywhere in the world, from Finland to New Zealand, regardless of market liquidity. As a result of these collective tendencies, the foreign investments of West Germany are widely dispersed across many countries and currencies.

German buying of U.S. bonds has virtually stopped now that U.S. long-bond yields are in the 8% range. Instead, according to statistics for the first half of the year, the main recipient of German funds has been the Canadian bond market. The second-favourite was the French bond market. Other major recipients of German capital included the Irish, Dutch, and Australian bond markets.

.....ALL THIS ON TOP OF A SOARING GERMAN EXPORT SURPLUS

The reversal in the German long-term capital account is certainly remarkable. Yet, so far, this momentous development has attracted little attention. Similarly, little notice is given to a new and sizable jump in the German current-account surplus, bloated by rising investment income from rapidly accumulating foreign assets and a surging export surplus.

To the mid-point of 1989, West Germany has run a current-account surplus of DM 55.9 billion, some \$15 billion or 37% higher than in the same period a year ago. Both exports and imports are up by a staggering 19%. Given a much higher export base, a similar increase still means a rising export surplus in nominal terms.

U.S. and German Trade Numbers Compared: Apples to Oranges. The recent apparent improvements in the U.S. trade accounts - a point which has been widely trumpeted and fussed about as a major underpinning to the strong dollar - are diminished when compared to the recent German export performance. The U.S. trade deficit for the first five months of 1989 has actually declined by \$5.86 billion, or some 6.6% against a year ago.

U.S exports, for example, gained a respectable 15% between these two periods. Surely, as a percentage, that performance appears striking and seems to be in the same league as that of West Germany. Yet, in reality (and without malice), it is an utterly misleading comparison for a very simple reason. The percentage figures apply to completely different export bases. In West Germany, merchandise exports account for 34% of Gross National Product (GNP) whereas in the United States, exports account for barely 7%. The German export base is approximately five times larger than that of the United States.

Improvement Only the Passive Result of Relative External Conditions. Two factors downplay the past improvement in the U.S. trade balance. Firstly, it must be recognized the improvement is truly modest when seen against the backdrop of highly-robust world demand conditions, especially in Europe, Japan and the newly-industrialized countries (NIC's). Secondly, considerable unused capacity existed in the U.S. whereas all of the former countries faced much higher capacity utilization levels.

From this perspective, the U.S. trade performance makes very poor reading. Here is an international locomotive speeding along with the U.S wagon decoupled and sitting on the side-line.

MANUFACTURING: THE KEY TO TRADE DEFICIT

Actually, the picture is more troublesome than it appears if one singles out the trade balance in manufactured goods. Clearly, this was the sector that caused the explosion of the U.S. trade and current-account gap. In like fashion, the bulk of the deficit reduction must occur in this sector over the long-run. And also, it is the trade sector that should logically reflect the major benefits of improved competitiveness through dollar-devaluation.

On those last points some retrospective. From 1981 to 1987 the U.S. trade balance in manufactured goods moved from a surplus of \$15.5 billion to a record deficit of \$153.7 billion. In total, this was more than the entire slippage of

the overall merchandise trade account and closely paralleled the deterioration in the current account.

Effectiveness of Dollar-Devaluation Remains Tenuous. If much of that earlier deterioration was attributable to a high-dollar, how then did U.S. trade in manufactured goods fare after dollar-devaluation? The effects of dollar-devaluation have not been in strong evidence so far.

To review one of our earlier letters, the U.S. trade deficit improved by a spectacular \$33.6 billion in 1988. That did duly impress international capital markets as being the sweeping success of devaluation. But, in reality, most of the gains had come from beneficent effects of falling oil prices, high agricultural exports and large Taiwanese and Japanese gold purchases from the United States. All of this had nothing to do with dollar-devaluation. Manufactured goods, by contrast, contributed a paltry plus of only \$6.9 billion - an improvement which, in light of the massive trade volume of \$585 billion must be seen as incredibly puny.

Trade Improvement This Year Still Measured. Considering the latest trade balance results for June, the performance for the whole of 1989 looks better. The trade deficit for the first six months amounted to \$54.9 billion versus \$60.2 billion for comparable period in 1988 - an improvement of \$5.86 billion or 10.8%. For industrial goods, the deficit declined from \$53.9 billion to \$48.5 billion. While showing some improvement, although surely modest, we doubt that these results are sufficient basis for the rather euphoric assessment of foreign exchange markets.

We still must regard the manufactured trade performance as disappointing given the extremely favourable back-drop of international demand. Nevertheless, trade improvement has been just enough to cover the rising interest costs resulting from the increasing indebtedness to foreigners.

A SERVICE MIRACLE JUST IN TIME

Given this modest trade improvement, it seemed pretty sure that the U.S. current-account deficit would not have improved at all for the whole of 1989 - assuredly to the sharp disappointment of exchange markets. But, just in time, the U.S. government has discovered a "motherlode" of gaps and inaccuracies in its tally of service exports which now prompts beneficial revisions. At the mere stroke of a pen, just like in the surreal world of cartoons, the current account now will appear improved.

Although the details have yet to be published, the latest GNP report already gives an indication that revisions will run into big figures. For example, this recent report shows a downward revision of the first-quarter real net export deficit from \$89.5 billion to \$55 billion (at an annualized rate). During the second quarter, the net real export deficit fell to \$52.5 billion. To say the least, that's quite a slash, but it seems that few observers have taken any notice, probably because this information was buried within the GNP report. Still, we do wonder how the currency markets will react to the news of a steep decline in the current-account deficit when the U.S. Commerce Department releases its mid-September current-account report.

In reality, of course, these current-account revisions are more optical than

fundamental. After all, the overall balance of payments remains unchanged. What happens is only a shift of statistical classification from "errors and omissions" to "service exports". More precisely, unidentified receipts which used to be labelled as "errors and omissions" and ascribed to "unidentified capital inflows" have been turned into "unrecorded service exports".

While service exports have been revised upward, capital inflows are revised downward by the same amount. As it happens in the latter category, these figures are more a function of estimates than measurement in any case. And, it should be noted, that as these revisions add to service exports, they also correspondingly add to GNP growth. Optimists are sure to ignore all this superficial pencil-work and use the ostensible appearance of these numbers to the advantage of their case.

RAMPANT OPTIMISM: BUT OPTIMISM OF WHOM?

Given the buoyancy of the dollar and Wall Street, one is tempted to conclude that the markets must be rampant with optimism over the U.S. economy. Yet, time and time again we ask ourselves just who is it that is so optimistic? What we seem to find is that a relatively small group, although powerful and very influential, successfully seems to portray their narrow views to the majority.

In that respect, the case seems to be very similar for all U.S. financial markets including stocks, currencies and bond markets. In most cases, it's the speculators and the trading fraternity who call the tune while professional analysts imaginatively pen the corresponding lyrics and just follow the bouncing ball. And what then is called "market opinion" or "market optimism" (in reality just cocky explanations and daffy theories) is churned into the daily media grist of the legendary and mythical creature of "consensus opinion" (which virtually never even harbours a smidgen of pessimism).

The stock market is a prime example of a narrow interest group affecting the viewpoints of the majority. It's a particularly suitable case-study because detailed statistics are available and sellers and buyers are easily identified. With few exceptions recently, most major U.S. stock markets have all recaptured their 1987 bull-market highs. So, from that perspective a buoyant U.S. stock market seems well-matched with a strong dollar. Understandably, there is widespread opinion that both reflect the same thing: namely, the underlying strength of the U.S. economy. But this inverted pyramid of optimism seems to be founded on the optimism of just one type of equity buyer: the corporation.

CORPORATE MERGER MANIA AT THE SOURCE

Most reports convey the impression that the exuberance expressed in the stock market is just the natural reflection of extremely favourable developments both in the economy and the stock market including easier money, lower inflation and healthy profits. The more favourite arguments supporting bullish stock markets are the more graphic ones, for example that "investors are awash in cash" while the amount of "equity supply continues to dry up".

Superficially, that is all true but the fundamental reasons are all sheer nonsense. The fact that Wall Street enjoys favourable market trends has very little to do with normal stable-rooted market forces such as a robust supply of savings and strong financing demand for capital investment. Rather, everything

depends on one thing only - corporate leverage and merger-mania financed by an seemingly unlimited supply of credit. Last year, mergers and acquisitions extinguished roughly \$300 billion of outstanding corporate equity. On top of that, companies bought back \$40 billion of their own shares while only issuing less than \$40 billion of new stock.

It's clear enough that this giant "sunami" wave of corporate stock repurchases - fuelled by borrowed money (credit inflation in other words) - was the engine that has been driving stock prices up and swamping individual and institutional investors with their oft-cited "over-liquidity". The fact is that the U.S. stock market has been uncoupled from the real economy of the U.S. and long ago ceased to perform any of the normal functions of a capital market - namely that of financing economic expansion.

The only game in town is to pick take-over candidates. Genuine long-term investment is dying a fast death. Shares of companies that are not suited for a takeover, like IBM, are neglected and lag the market. The consequence of all this is that the buoyancy of this market says really nothing about the economy or about the sentiment among genuine long-term investors. In fact, by all accounts, value-based, long-sighted investors have been liquidating stock market holdings. Nevertheless, whatever the underlying reason, a rising stock markets contributes greatly to the general bullishness about the U.S. economy and its currency.

THE ROTATING MANIA TURNS TO U.S. BONDS...

It is our view that the kind of feverish speculation reflected by stock markets - whipped up by the ferment of dubious and sleazy arguments catering to a "quick-hit" investor mentality - is just as evident in U.S. bond markets. No sooner had long-bond yields fallen to 8% (from levels of over 9% previously) than did forecasts of smaller "hat-size" yields of 7% and even 6% ring out.

Disinflation and similar nonsense is back again. And it has also become a very favourite story that the inflation spread between West Germany and the U.S. is likely to worsen. German inflation is supposedly heading for 4% while U.S. inflation is moderating to 5% and lower.

...FED BY TWISTED COMPARISONS BETWEEN GERMAN AND U.S. INFLATION RATES

When reading such reports one gets the strong impression that economic statistics read differently in metric than in British units. American and British analysts swarm when they write about the U.S. economy and then take the good economic performances of Europe, and Germany in particular, for granted and measure them on a different scale.

Inflation is Up... It is true that the German inflation rate has picked up sharply to a year-over-year rate of 3% as compared to a 1% rate in June of 1988 and 1.6% even as late as last December. The question now becomes whether this upward burst is simply a prelude to much higher inflation or simply the result of one-time events.

Based on the supporting arguments that the German economy is overheating and that Bundesbank monetary policy has been rather lax, many American and British economists have concluded that an inflation run-away might be the more likely

prospect. On the other hand, they regard U.S. monetary growth as extremely tight thus forewarning moderating inflation, if not a return to "disinflation" or even deflation.

Let us start with a forecast and then subsequently follow with its substantiation. Early, next year, the German inflation rate, as measured by consumer prices, will drop to a level signified with a "2" before the decimal. West German core-inflation remains unchanged at around the present 2% range while U.S. core-inflation will have moved up to 5-6%, up from the current 4% range.

But, West German Inflation Forces....In Germany's case, one has to make allowances for a number of temporarily-adverse influences. To begin with, earlier in January, the imposition of various newly-introduced consumer taxes boosted the price index by 0.8%. Then came the effects of sharply higher oil prices later in the year as well as rising import prices due to the weakness in the D-Mark. Not last of course, we can't overlook the booming German economy. Given all these adverse influences it seems remarkable that inflation didn't accelerate any more. During the last three months German CPI rose only 1.9% at a seasonally adjusted annual rate.

....Very Different From Those of the U.S. Now let's compare the German inflation performance with that of the United States. Inflation in the U.S., as measured by the CPI, rose 5.2% against a year ago and 5.7% during the last three months. These rates however, have to be seen against the backdrop of a weakening economy together with the inflation-suppressing effects of a huge trade deficit and a stronger currency. Taking all these mitigating factors into account, we are, frankly, at a complete loss to understand how the recent U.S. inflation experience can be viewed as positive, let alone favourable in comparison with Germany. So much for the superficial argument of a sharply narrowing inflation gap between these two major countries.

SAVINGS AND PRODUCTIVITY GROWTH: THE KEYS TO LOW INFLATION

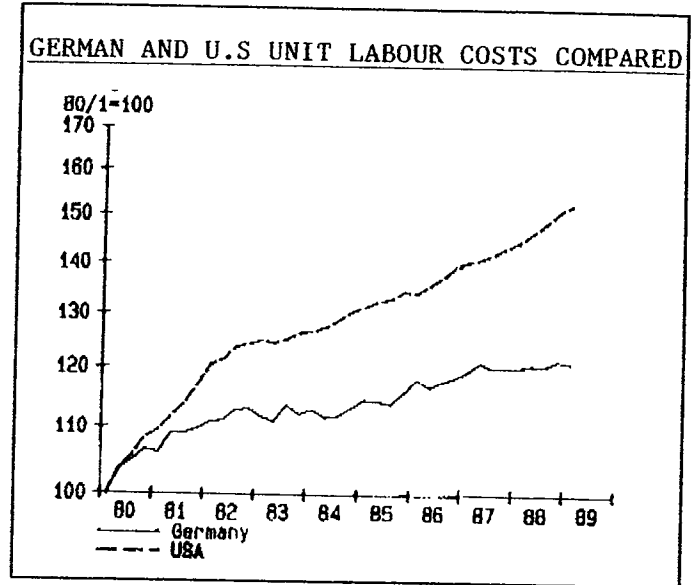
The extraordinary inflation resistance that the West German economy seems to exhibit has two deeper-seated causes of a type that are entirely ignored in the whole analysis of inflation today. The inflation-suppressing effects of a high savings rate and high productivity gains (that keep a lid on unit labour costs) are rarely, if ever, considered.

The Inflation-Aquifer of Unit Labour Costs...The stronger inflation bias of the U.S. economy, by contrast, has a deep root in an abominably low savings rate, along with an anaemic investment rate that's associated with a miserable productivity performance. These deep underlying aquifers of inflation, rather than portending improvement in inflation trends, instead point to a worsening - a conclusion for which we've already laid out our analytic basis in recent letters.

Since early 1980, German unit labour cost in the overall economy have advance by 18%. During the same period, unit labour costs in the United States advanced by 50%. Between the first quarter of 1988 and the second quarter of 1989, overall German unit labour cost rose by 0.6% while U.S. costs rose by 6.3%. (See the graph on the opposite page).

...and Savings Trends Compared. Again, in terms of available savings, the difference between the two countries is just as striking. In the United States, the national savings rate - that is personal and corporate savings minus the dis-saving of the government - dropped markedly during the 1980s to an average of about 2.0% of GNP as compared to about 6.5% of GNP during the 1968-1982 period.

Over the same period, the West German national savings rate increased from 9% of GNP to approximately 16%. The sharp upward movement was mainly attributable to higher corporate savings and a lower budget deficit, while personal savings stayed at their high levels. Germany is the only big industrial country where households save a larger chunk of their incomes than ten years ago.



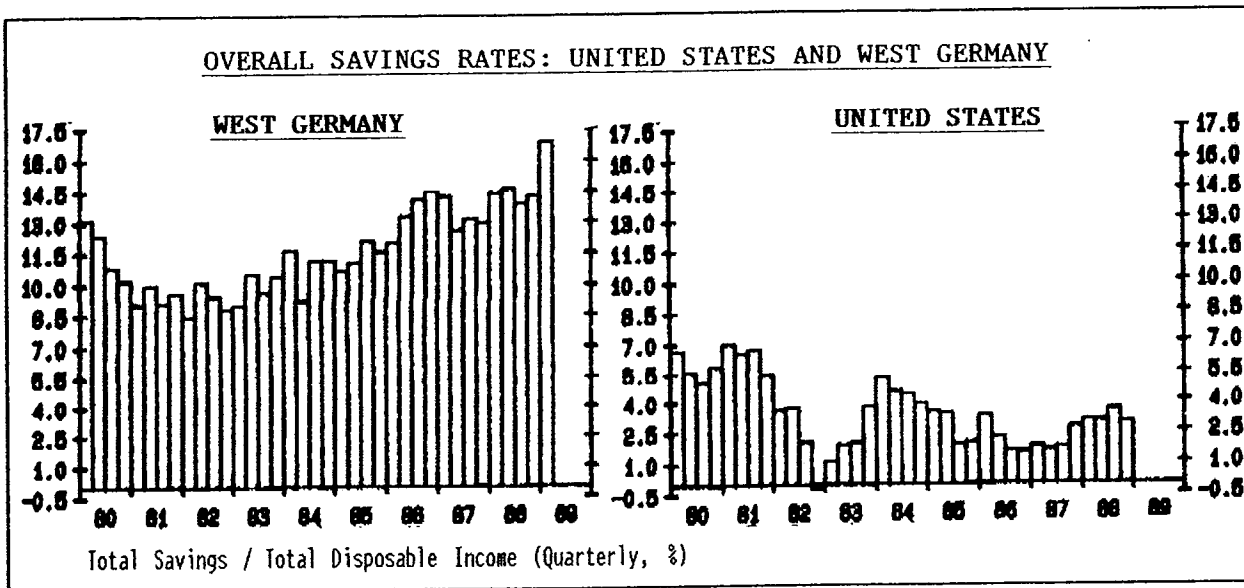
The charts on the next page highlight the incredible contrast between the German and U.S. national saving rate (defined as personal plus corporate savings minus the national budget deficit).

Savings are the long-term governor of inflation for a country since it is savings that essentially sets the limits to investment and productivity growth potential. Considering the U.S. aggregates that show a miserable savings performance - in fact, by far the worst among all industrial countries, excepting Britain - the compelling conclusion is that inflation is bound to remain endemic. One has to realize that private and public consumption absorb 97-97.5% of net GNP in the U.S.. That in turn means that investment - and any other potential type of control on domestic inflation trends for that matter - are critically dependent on foreign capital inflows.

PORTRAIT OF A PICTURE-BOOK RECOVERY

From a cyclical point of view, German interest rates may not yet have peaked since the economy still continues to boom. Renegotiations for the long-term wage contracts that are slated for early next year may yet represent uncertain risk for inflation and interest rates. In that respect, it will be important that inflation should again be trending downward before that time arrives. But because the effects of the increase in consumer taxes at the start of this year will drop out of the index by early 1990, a marked slow-down in inflation already seems assured.

In the meantime, Germany's economic growth is exceeding all expectations. What's more, it is a veritable "picture-book" recovery, especially when viewed in terms of economic composition. Most of the growth results from buoyant exports and investment while consumers continue to save and refrain from spending their windfall from recent tax cuts.



Both domestic and foreign order books point toward sustained and strong economic growth for the remainder of this year and well into next. High capacity utilization rates and business profits are further stimulating capital investment. Next January, the final phase of tax reform plans will kick in and pump in DM 25 billion into the economy, the equivalent of 1% of GNP.

SOME FORGOTTEN DETERMINANTS OF INTEREST RATES

The one thing that may be said against the immediate purchases of DM-bonds is that the German Bundesbank (central bank) will not ease in the foreseeable future. From a relative perspective, that expectation is also being offered as the big argument in favour of U.S. bonds. But the point of differentiation here is between the short-term monetary/cyclical and long-term fundamental evaluations ...in other words between speculation and investment.

We want to emphasize, though, that euphoria in the U.S. bond market can at best be regarded as nothing more than a swell of short-term speculative forces. In due time, most of these speculators will take profits (or be forced to minimize losses), driving interest rates up again. After all, from a long-term, fundamental perspective relative U.S. rates are unsustainably low.

Why Relatively Low U.S. Interest Rates Are Unsustainable. For one, relative inflation trends argue higher relative U.S. rates. The effects of exceptionally low savings, investments and the correspondingly poor productivity performance gives the American economy a strong underlying inflation bias, as we've so often stated. Besides, the Fed's resolve to fight inflation has always melted away at the first sign of recession. And that's already what has happened.

The foot was eased from the brake even though inflation still hovered at 5%. One has to conclude that there has been a sharp upward shift in the tolerance for inflation with 5% now being seen as a tolerable minimum. Indeed, many commentators are already willing to categorize such inflation levels as disinflationary. In the past, such levels of inflation used to trigger alarms, not visions of a return to disinflation.

....Inflation: The Chameleon. Moreover, one must realize that it is only because of the large trade deficit that price inflation isn't higher than it already is in the United States. Without it, there would probably be double-digit inflation rates. Billions and billions of credit-inflated dollars have been flowing out to buy foreign goods. Instead of manifesting itself entirely in domestic price inflation, the excess demand fuelled by excess credit has largely been absorbed by soaring imports. While wrecking its manufacturing industry, the United States succeeded in exporting its domestic inflation. Foreign borrowing, to an extent, has come to replace the domestic printing presses of money and credit.

Both U.S. inflation and interest rates are well below what domestic conditions warrant. A correction in the trade deficit or a sharp fall in foreign capital inflows would end all these superficial benefits and contribute to a boost in inflation together with a rise in interest rates. A fall in capital inflows will be a negative complication since it also implies a falling currency.

The failure to take these external factors into account is the one overpowering reason why we object to the common and simplistic comparisons of inflation and interest rates. Equally simplistic and misleading is the widespread practice of relating the movements of bond yields mainly or exclusively to changes or expected changes in the inflation rates.

On that last point, a brief refresher course on interest rates might be appropriate. Basically, interest rates are determined by credit demand relative to available savings. It is clear that credit demand in the United States continues to run far in excess of available savings. Otherwise there wouldn't be a trade deficit. If U.S. interest rates were truly restrictive, such a big excess of borrowing over the supply of savings would not be possible.

Again, please take a look at the two charts on page 10 which show the relative domestic supply/demand conditions of the US and Germany. From that perspective, U.S. interest rates are far too low and German interest rates, given the huge excess of savings over credit, are far too high. What distorts or "equilibrates" them, are the obliging but contrary huge capital flows.

The main point and conclusion is this: The over-riding determinant that cannot be ignored in any medium-term interest rate forecast is the critical link of international capital flows.

GRAND OPTIMISM AND SMALL TALK ABOUT A SOFT-LANDING

In conclusion let us state one more thing. It is hard to conceive of a more sterile discussion than that concerning itself with the prospects for a "soft landing" of the U.S. economy. The major question which America - and the rest of the world - now have to face is not some temporary cyclical weakening followed soon by the next upswing, but the long-term consequences of unprecedented credit and debt excesses that have thrown the economy and its financial system out of equilibrium as never before.

The extent of these excesses and maladjustments makes a deep recession (and/or a prolonged phase of "stagflation") punctuated by financial upheavals and a steep fall in the dollar virtually inevitable. Only the timing remains in question. The talk of a soft-landing only deals with the prospect of a short

deferral of the inevitable.

Meanwhile the Dow is off towards a widely-expected rendezvous with its pre-crash highs. It is only the U.S. dollar, U.S. stocks and bonds that remain the strongest part of the economy - thanks to help of Wall Street hype. After all, it is primarily these high profile elements that determine the optics and perception of daily media headlines.

But the question to wake up to is this: What is more critical for America's economic health - bullish emotions in the financial markets or the unprecedented lows in savings and investment, extremely poor productivity performance, the trade deficit and soaring foreign indebtedness, a recklessly over-leveraged corporate America, the S & L's multi-hundred-billion dollar disaster, the budget deficit and endemic inflation at around 5%?

Considering America's economic and financial "fundamentals", two things are sadly obvious: first, that they virtually guarantee a further erosion of America's standard of living; and second, that this debt-ridden economy will be very vulnerable in the event of a recession.

For the time being, though, attention to these important determinants are completely eclipsed by an all-consuming preoccupation for short-term speculation. The only focus of concern is the immediate market-effect of the next economic statistic.

To be sure, worldwide speculation remains pro-Wall Street and pro-dollar for the time being. Indicative of this sentiment is a selective perception that bends any financial or economic event to conform to a bullish implication for Wall Street and the dollar.

Should the economy weaken and interest rates fall, it is bullish; should America's economy strengthen and interest rates rise, it is heralded as being equally positive for the U.S. markets and the currency. When U.S. trade figures are bad, we are told that only capital flows matter. When the figures look better, the trade balance suddenly becomes all-important rather than capital flows. All of this simply underlines a strong desire to be bullish. Facts aren't any impediment.

And last, one would be remiss to forget that it was as little as two years ago that the U.S. dollar needed long and massive central bank interventions to prevent a complete collapse.

Gauging from the recent performance of European equity markets, and the sizable shift of international capital flows (witness Germany's recent experience) it seems that the European success story versus that of the U.S., at long last, is beginning to filter down to investors. If so, it won't be long until these facts filter down to the currency markets.

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